No. 7892

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In the United States Circuit Court of Appeals

For the Ninth Circuit.

Commissioner of Internal Revenue,
Petitioner,

vs.

Elliott Petroleum Corporation,
Respondent.

BRIEF FOR THE RESPONDENT.

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Preliminary Statement.

This appeal involves a deficiency in income tax for the year 1930 in the amount of $1,045.29, and was taken by the Commissioner from a decision in favor of the respondent handed down by the Board of Tax Appeals on January 3, 1935. [R. 52-56-57.]

The Commissioner filed his petition for review on March 19, 1935 [R. 58-63], pursuant to the provisions of *Sections 1001-1003* of the Revenue Act of 1932, as amended by *Section 1001* of the Revenue Act of 1932, *c. 209, 47 Stat. 169,* and by *Section 519* of the Revenue Act of 1934, c. 277, 48 Stat. 680.

Question Involved.

The only question involved is whether or not the respondent is entitled to a depletion deduction of 27½ per cent of the amount of money received by it during the year, under a contract entitling it to receive a certain sum of money to be paid out of one-half of the oil and gas produced from a lease.

Statutes Involved.

Two sections of the Revenue Act of 1928 are involved as follows:

Section 114 (b) (3) which reads:

> "Percentage depletion for oil and gas wells.—In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph."

Section 23 (1) which reads in part as follows:

> "Depletion.—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In the case of leases the deduction shall be equitably apportioned between the lessor and lessee."

Statement.

Inasmuch as all the facts were stipulated, it seems sufficient to merely outline the salient facts here.

Respondent, a California corporation, acquired, by assignment, in 1922, an oil lease on oil bearing land in the Santa Fe Springs Oil Field. [R. 10.]

In 1928, when the property was producing oil and gas [R. 48], and when respondent had a considerable investment in the lease [R. 11], it entered into three agreements respecting the lease, with Richfield Oil Company of California. These agreements were called "Assignment of Oil and Gas Lease", "Bill of Sale", and "Collateral Agreement", respectively. [R. 10-11.]

By the agreement marked Exhibit "C", respondent purported to assign the lease to Richfield. [R. 36-38.] By the agreement marked Exhibit "D", respondent purported to sell the equipment on said leased premises to Richfield. [R. 43-46.]

By the agreement marked Exhibit "E", respondent was to receive, as a part of the same transaction out of which the agreements marked Exhibits "C" and "D" arose, $137,500 in cash, and an additional $137,500 to come out of one-half of the net proceeds of all production from the premises covered by the said lease. The Richfield Company agreed to drill another well to a deeper sand, and to comply with all the conditions of the lease (at least until respondent had received the second $137,500). Respondent was to have the right to enter upon the leased premises, inspect the production records of the Richfield Company, and to have monthly statements of production, as well as monthly payments, until the second $137,500 had been received. Should the Richfield Company abandon the lease or lose it by any default, while it was producing commercially and before respondent had received all of the second $137,500, then the balance of the $137,500 still coming to respondent, should became a personal and direct obligation of Richfield to respondent. [R. 46-51.]

Respondent received the first $137,500 in 1928 and received portions of the second $137,500 as follows:

1928	$19,494.58
1929	$35,797.68
1930	$69,699.81

[R. 11.]

Respondent had no deductions from such amounts, its gross income, in 1930, being the same as its net income from this source. [R. 11.]

ARGUMENT.

Respondent, in Acquiring and Developing an Oil and Gas Lease, Obtained, Through Investment, an Economic Interest in the Oil and Gas in Place and, in Retaining the Right to Share in the Proceeds of Production Therefrom, Retained Such an Interest and Is Entitled to a Depletion Deduction.

It is well established that a lessee of mineral bearing property is entitled to depletion deductions on production therefrom. *Lynch v. Alworth-Stephens Company,* 267 U. S. 364.

It is also settled law that one having a lease and transferring it to another, in considering of a bonus in cash, a further sum of money to be paid out of a portion of the oil produced, plus an overriding royalty of a portion of the oil produced, is entitled to depletion deductions on all of such amounts. *Palmer v. Bender,* 287 U. S. 551.

It has also been held by the Circuit Court of Appeals for the Tenth Circuit, that one who in transferring an oil lease reserves a portion of the oil to be produced until the proceeds of the reserved oil reach a certain sum, is entitled to depletion on the income arising from the production of the reserved oil, as well as on a cash bonus received when the assignment was executed. *Alexander v. Continental Petroleum Company,* 63 Fed. (2d) 927.

After the above decisions had been handed down, the petitioner, through his general counsel, ruled that a lessee assigning a lease for a portion of the net profits derived from the sale of the products of the leased land, was entitled to depletion. *G. C. M. 11,822, C. B. June, 1933, page 229.*

The Board of Tax Appeals has, in deciding several cases, allowed depletion deductions where the facts varied slightly from the facts involved in the preceding cases and ruling. For example, in *William Fleming v. Commissioner,* 31 B. T. A. 623, a lessee assigned a lease and received a sum in cash and was to receive an additional one million dollars out of oil. The contract specified that the Pipe Line Company which purchased the oil was to make the payments which were to come out of the oil. The Board allowed the taxpayer depletion on the payments which were made out of the oil.

In *Thomas A. O'Donnell,* 32 B. T. A. 1277, the taxpayer sold property to a corporation and thereby became entitled to one-third of the net profits derived from the operations of the oil properties. The Board allowed the taxpayer depletion on his portion of the net profits.

Similarly, in *Chester Addison Jones v. Commissioner,* 31 B. T. A. 55, a lessee assigned his lease for cash and a portion of the proceeds of the sale of the oil to be produced from the property. The Board allowed the taxpayer depletion deductions on his share of the proceeds from the sale of the oil. This case was appealed by the Commissioner to the United States Circuit Court of Appeals for the Fifth Circuit on January 3, 1935, but as late as January, 1936, the appeal had not been perfected.

In *W. S. Green v. Commissioner,* 26 B. T. A. 1017, a lessor was entitled to a royalty of 3/32 of the production, and ⅓ of the net profits of the lease. The Board held that he was entitled to depletion deductions on both interests.

The facts in the case at bar compare closely in substance and form, with the facts in the case of *Palmer v.*

Bender, supra, and in the case of *Alexander v. Continental Petroleum Company, supra.* In all three cases, the taxpayers were former lessees and signed papers called "Assignments of Leases". In all three cases, the transferor received a cash sum and was to receive a further sum dependent upon future production. In all three cases, the transferor had an interest in the oil in place, and in its production. All three transferors would have suffered economic losses if the respective oil reserves had been destroyed or the flow had been directed in other channels.

The fact that, in *Palmer v. Bender, supra,* the transferor received an overriding royalty in oil would not seem to be important. The Supreme Court did mention, *page 558,* that the lessees "retained, by their stipulations for royalties, an economic interest in the oil, in place, identical with that of a lessor". The word "royalties" referred to the advanced royalty or bonus, and the amount to be paid out of a portion of oil, as well as the overriding royalty in oil. It should be noted that the Supreme Court allowed depletion on the bonus and the sum paid out of oil.

Royalty is merely rent for the use of the mineral resources of land (*Higgins v. California Petroleum & Asphalt Co.*, 41 Pac. 1087) and its character is the same whether it is paid in kind (*Alexander v. King,* 46 Fed. (2d) 235), so much per year (*40 C. J. 1103*), a portion of the value of the products, a part of the net profits (*Potterie Gas Co. v. Potterie,* 36 Atl. 232), or a portion of the sales price of converted products (*Signal Gasoline Corporation v. Commissioner,* 66 Fed. (2d) 886). See *G. C. M. 3890, C. B. VII-1, page 168,* which states that a royalty is the right to a portion of the production, or the *proceeds* thereof. This court has, in *In re Lathrap,* 61 Fed. (2d) 37, held that persons entitled to percents of the gross proceeds received from the sale of the oil and gas produced and sold, have *royalty interests* and are participants in the enterprise with the lessee.

It is customary for the lessor to receive his royalty in cash. Advanced royalties or bonuses, received by lessors, are almost universally in cash, but are subject to depletion deductions. *Herring v. Commissioner,* 293 U. S. 322.

Respondent has, therefore, an economic interest in the oil, in place, identical with that of a lessor.

Furthermore, the fact that in *Alexander v. Continental Petroleum Co., supra,* the taxpayer was entitled to a portion of the oil when produced, rather than to the proceeds thereof, does not seem to have been given any importance by the Circuit Court of Appeals for the Tenth Circuit. The court, in comparing the facts of the case before it with the facts in *Palmer v. Bender, supra,* said, page 928:

> "There (in Palmer v. Bender) the depletion was claimed by Palmer, a member of two partnerships, which had sold certain leases. One of the sales was in consideration of a cash bonus and a payment 'out of one-half of the first oil produced and saved,' and the other was of like character. . . ."

If the right to receive oil, rather than the proceeds of oil, as produced, is the test of a depletable right, then the Circuit Court, in the above-named case, would have pointed out that the Continental Petroleum Company was to receive a portion of the *oil,* and that this fact brought the case on all fours with *Palmer v. Bender, supra,* where the taxpayer was to receive a portion of the *oil.*

It is the right to receive royalties of any kind that carries with it the right to depletion. After all, people engaging in the oil business, whether lessor, lessee, sublessor, or otherwise, eventually reduce their rights in the oil to money. Lessors and assignors of leases usually do not have the facilities to handle the oil received as a royalty in kind. It should not make any difference, in the case at bar, whether respondent was to receive one-half of the oil, until the market price of that one-half, as produced, equalled $137,500, or whether respondent was to receive the proceeds from one-half of the oil produced until its receipts reached $137,500. In either case the Richfield Oil Company would have undoubtedly actually taken the oil and have given respondent the same amount of money.

The petitioner suggests, on page 15 of his brief, that the case is no different than it would be if the entire sum of $275,000 had been paid on the transfer, and cites *Darby-Lynde Co. v. Alexander,* 51 Fed. (2d) 56, certiorari denied, 284 U. S. 666. The respondent points out, however, that in this case the entire sum of $275,000 was not paid on the transfer. The Richfield Oil Company said, in effect, "We will gamble to the extent of $137,500. For any further sum you must show by actual happenings the value of the mineral content. Even then, we will cease payments after one-half of that interest has produced $137,500."

It is clear from the terms of the contract that the respondent had an economic interest in the oil and lease and its interest became depleted by production.

The petitioner cites *Pugh v. Commissioner,* 49 Fed. (2d) 76, certiorari denied, 284 U. S. 642, as being authority for the proposition that one assigning one-half of his royalty interest for a consideration of $250,000, of which $50,000 was payable at once and $200,000 out of future production of oil, is not entitled to depletion deductions. That case, however, was decided before the Supreme Court rendered its decision in the case of *Palmer v. Bender, supra,* and, of course, is overruled by the latter case.

The petitioner cites the case of *Comar Oil Co. v. Burnet,* 64 Fed. (2d) 965, certiorari denied, 290 U. S. 652, as authority for the proposition that the deferred payment in this case was not a reserved royalty. In that case the taxpayer secured a lease of oil land for a consideration of $50,000 in cash and $100,000 to be paid out of one-eighth of the gross production of oil and gas. The taxpayer claimed the right to deduct the payments, made out of oil under these leases, from gross income on the ground that they were royalties. The court held that the payments were not royalties but were capital expenditures made in connection with the acquisition of capital assets. The *Comar Oil Co.* case, however, did not involve the question of depletion. Furthermore, this court has already held that persons entitled to percentages of the gross proceeds received from the sale of oil and gas produced and sold, have royalty interests. *In re Lathrap,* 61 Fed. (2d) 37.

The fact that respondent may have recovered its investment in the lease prior to the taxable year is of no consequence as the percentage depletion provided for in *Section 114 (b) (3)* of the Revenue Act of 1928, is not dependent on the investment in the oil content or lease.

The petitioner's argument, appearing on page 18 of his brief, that the depletion allowance, under the circumstances of respondent's claim cannot be computed, overlooks the fact that the parties have stipulated the amount of the depletion deduction in the event the respondent is entitled to a deduction for depletion. [R. 11.] The lessor would deplete his royalties received, and the assignee-lessee would take depletion deductions on the gross income of the property less royalties paid to respondent and the lessor. Thus each party will have a depletion deduction in proportion to the diminution, through production, of his share of the oil in place.

Respondent submits that by retaining the right to share in the proceeds of the oil when produced it has retained an economic interest in the oil in place and is, under the statute and the decisions cited herein, entitled to a depletion deduction.

Respectfully,

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January, 1936.